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Central America: Economies in Crisis

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An Intelligence Assessment

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ALA 83-10175
November 1983

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Erratum

Notice to recipients of DDI Intelligence Assessment: *Central America: Economies in Crisis,* ALA 83-10175, (Confidential November 1983.

Please replace figure 4 on page 8 and figure 6 on page 11 with the figures below.

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Figure 4
Central America: Gross Domestic Investment as a Share of GDP

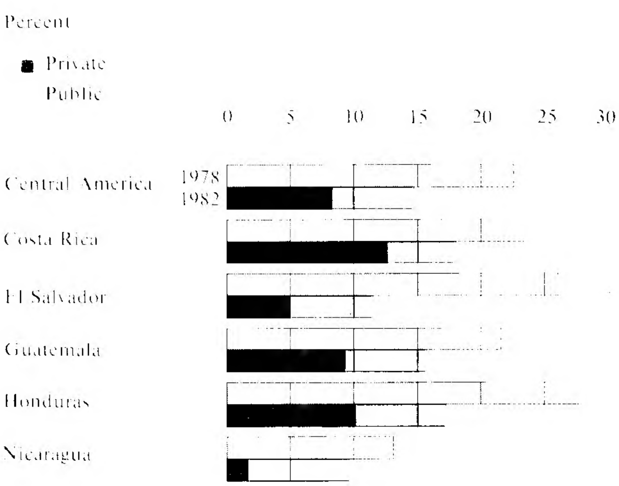

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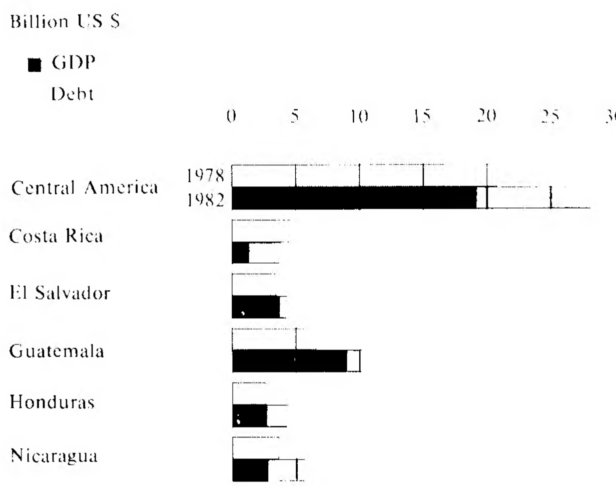
Figure 6
Central America: External Public Debt Compared to GDP



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Central America: Economies in Crisis [redacted]

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This paper was prepared by [redacted] Office of African and Latin American Analysis. [redacted] 25X1

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Comments and queries are welcome and may be directed to the Chief, Middle America–Caribbean Division, ALA, [redacted] 25X1

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Central America: Economies in Crisis

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Key Judgments

Information available as of 25 October 1983 was used in this report.

Persistent disruptions caused by insurgent activity and the global recession have choked economic activity and boosted foreign aid needs throughout Central America. Economic performance has been dismal since 1979, when revolution in Nicaragua and coordinated guerrilla activity in El Salvador and in Guatemala coincided with deteriorating terms of trade for the region. As a result, in the three years following 1979, real economic activity for Central America plunged roughly 20 percent.

In the countries most directly affected by insurgencies, destruction and production losses caused by the fighting have been a major component in the economic downturn. The economic interdependence of the region has spread economic ills even to those areas not directly hurt by fighting, and domestic investment has deteriorated sharply throughout the region. Foreign commercial lending has nearly dried up, and regional trade, formerly the outlet for virtually all of the area's manufactures exports, has been hamstrung by payment arrearages, import restrictions, and barriers to currency convertibility. Violence in the countryside has been impeding traditional seasonal labor migration throughout the region and cutting into harvests.

Global economic developments have also contributed to the area's woes. A sharp rise in oil prices, weakening demand for agricultural commodities, and skyrocketing interest rates caused the regional current account deficit to balloon from roughly $750 million in 1979 to more than $1.5 billion in 1982 despite deep cuts in import volume. In response, Central American countries drew down foreign exchange reserves by $2 billion and secured foreign loans—mainly from official sources—worth about $6 billion during 1979-82.

Even with a pickup in the world economy, the outlook for 1983-84 depends largely on security conditions. If insurgent activity continues near current levels, we calculate—on the basis of simple national accounts modeling and payments forecasting—that the foreign aid tab to sustain import volumes, prop up living standards, and forestall further drops in real output would reach roughly $2.5 billion each year. We estimate that the region will receive only about $1.8 billion this year, despite growing appeals to traditional bilateral OECD (Organization for Economic Development and Cooperation) lenders and multilateral institutions. As a result, we estimate that import volume will decline and overall economic activity in the region probably will fall by 3 to 5 percent this year. Economic performance will continue to deteriorate in 1984 unless unanticipated aid materializes.

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Foreign economic aid will play a pivotal role in ensuring stability in this troubled region in the years ahead, in part because insurgents will take advantage of continuing economic decline in their campaigns to gain popular support. The generosity and promptness of official donor responses will determine not only whether living standards can be stabilized or will continue to erode but also whether individual governments can muster the will and resources needed to pursue the political, economic, and social reforms essential to sustain any recovery over the longer run.

In any case, the danger of sudden major economic setbacks is great. Should insurgents make strong gains, governments would be hard pressed to contain investor panic or channel aid into productive investments. Assistance would be used to sustain imports and living standards; no likely amount of foreign aid could spark economic growth. Moreover, an upsurge in the flight of capital and talent would further cripple these economies.

Despite the central importance of military unrest in Central America's problems, decisive military victories over the insurgents would not by themselves be enough to generate quick economic improvement. Even if global economic recovery were faster than generally expected, the region's private sector, weakened by years of political turmoil, capital flight, low levels of investment, and dwindling inventories would take several years to recover. In these circumstances, foreign aid needs would most likely remain high for perhaps five to 10 years. Although we believe that an improved military and political climate might bolster aid receipts, if foreign assistance fell substantially short of requirements, there would be a high risk that economic recovery would be jolted.

If significant insurgent activity continues beyond mid-decade, the costs of eventual economic reconstruction would burgeon as insurgent-inflicted damage mounted, capital stock deteriorated, and middle class emigration grew. In a reversal of past regional development trends, governments—rather than the private sectors—would set the economic course and could be quickly overburdened. With a shriveled tax base and little access to foreign private capital, these countries—with the obvious exception of Nicaragua—would turn increasingly to the United States for aid.

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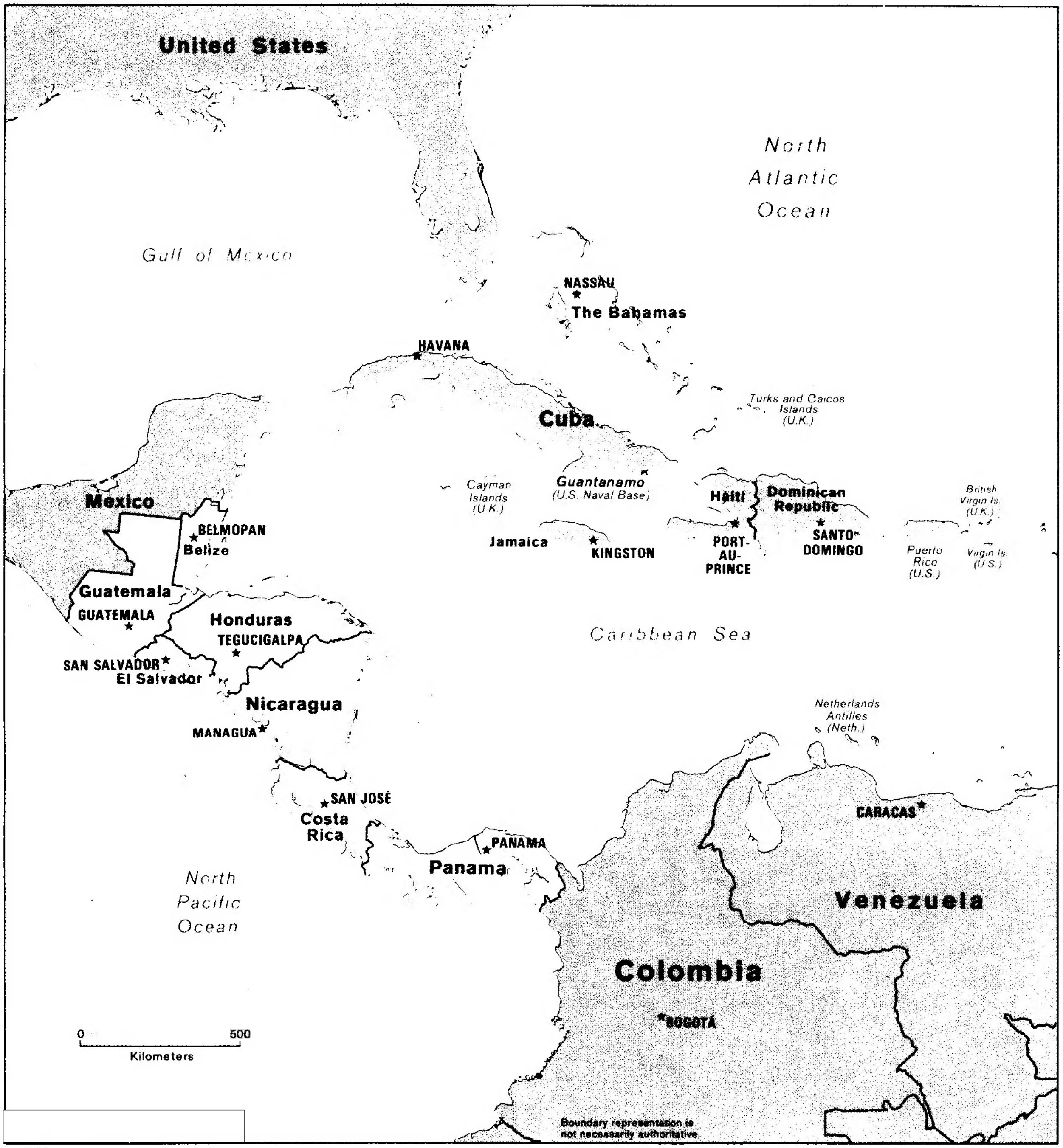

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Central America: Economies in Crisis

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Introduction

The small, strategically located countries of Central America are coping with insurgencies and subversion that are challenging the tenuous military and political balance in the region.[1] Although actual fighting thus far has been limited to El Salvador, Guatemala, and Nicaragua, economic deterioration is being transmitted throughout the isthmus by the strong investment, trade, currency, and labor ties that had contributed to previous regional development. Since the violence escalated in 1979, regional economic activity has been plummeting as investment dries up, intraregional trade slows, guerrilla intimidation and the fighting disrupt migrant agricultural labor flows, and capital flight depletes foreign currency holdings. Steep world interest rates and soft agricultural commodity prices are compounding these difficulties.

This paper draws together in-depth research completed on individual economies in Central America in order to examine the similarities and dissimilarities in their paths of economic development, trace the buildup of economic stress and review recent performance.[2] It assesses foreign funding requirements associated with various economic growth tracks through 1984 for the region as a whole and considers their sensitivity to various security conditions. This assessment also evaluates the economic danger points of a prolonged insurgency and draws the implications for US interests.

[1] For this assessment we include Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua and exclude Belize and Panama from our discussion.

Shallow Foundations, Rapid Growth: 1961-78

Although the Central American countries vary tremendously in economic development levels and strategies, they shared important similarities and linkages that provided the foundation for fast-paced economic expansion for much of the period since World War II until 1979. During 1961-78, for example, Central American economic growth rates matched the Latin American average of 5.6 percent per year and surpassed that of LDCs as a whole. Costa Rica led Central American countries and sustained growth rates in excess of 6 percent per year, while Honduras trailed only slightly at roughly 5-percent annual expansion. These common growth paths—built on periodic booms in agricultural commodity prices, dynamic, regionally protected manufacturing sectors, and widespread foreign borrowing—failed, however, to foster sturdy, broad-based economic expansion. 25X1

Agriculture, the keystone of the region's economic development, was the primary source of export earnings and employment. Despite wildly fluctuating international prices for major commodities—coffee, sugar, bananas, cotton, and meat—the region's longstanding dependence on these items for more than three-fourths of export earnings did not lessen. Indeed, a threefold increase in coffee and sugar prices in the mid-1970s helped compensate for the 1973 OPEC oil price hikes. These vital crops were harvested by large numbers of workers who seasonally migrated internally and across the isthmus. Altogether, slightly more than half the Central American labor force was employed in agriculture in the late 1970s. 25X1

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Agriculture also provided the springboard for industrialization; in addition to the 26 percent of Central American economic activity directly attributable to agriculture in 1978, 75 percent of the fast-growing

Central America: Dimensions of Poverty

Although sharp disparities exist among individual Central American countries, various measures of living standards sketch an outline of poverty in the region that generally falls between the dirt-poor levels of LDCs as a whole and the comparatively affluent standards of Latin America.[a] *This information tends to refute the widespread notion that poverty rather than other factors has been the main cause of regional unrest.*

- *Before the turmoil broke out in 1979, average per capita incomes in Central America surpassed LDC levels by more than 40 percent but measured little more than half of Latin American earnings. The range within Central America was broad, however, as the typical Costa Rican enjoyed an income more than triple that of his Honduran counterpart.*

- *Land ownership patterns suggest that income during the early 1970s at least was more evenly distributed in Central America than in LDCs overall. (Income distribution data are unavailable.) Seventy-eight percent of cropland in Central America was divided into very small plots, as compared to 87 percent in LDCs as a whole and 59 percent in Latin America. El Salvador and Guatemala exhibited the highest concentrations of tiny farms in Central America, while Costa Rica and Nicaragua claimed substantial numbers of moderate-size holdings.*

- *A baby born in Central America in 1979 could expect to live seven years longer than the LDC average and roughly as long as the average Latin American child. A Costa Rican infant could look forward to his 70th birthday, while a Nicaraguan newborn, on average, would survive to age 56.*

- *Slightly more than half the population of Central America had access to safe water in the mid-1970s, as compared to less than 40 percent in LDCs generally and 65 percent in Latin America. Nearly 80 percent of Costa Ricans could count on a potable water supply—almost twice the share for Guatemalans.*

- *Although all other Central American countries matched or exceeded LDC primary school enrollment rates in the late 1970s, extremely low Guatemalan education levels dragged the Central American average below that of both LDCs as a whole and Latin America. Seventy-eight percent of Central American children attended primary school, as compared to the 80 percent LDC average and 93 percent of Latin Americans. Despite low per capita incomes in Honduras, 85 percent of children there were enrolled in school.*

- *Electric lights were found in about one-third of Central American homes in the mid-1970s, as compared to slightly more than half in Latin America. (Worldwide LDC statistics are not available.) Two-thirds of Costa Ricans enjoyed electric lights, while more than 80 percent of Hondurans still relied on lanterns and candles.* 25X1

[a] *With the exception of per capita income data, socioeconomic indicators from the 1970s are the most recent available. Although they portray living standards in Central America prior to 1979, they do not reflect the dramatic deterioration that has afflicted some countries since then.* 25X1

manufacturing sector was related to agriculture. Food processing accounted for nearly half of manufacturing activity. Textiles, wood, paper, and rubber production together accounted for another 25 percent of this sector's output

The nascent manufacturing sectors provided the most energetic component of regional economic growth. UN data show that Central America's industrial base expanded at an average annual rate of 7.4 percent during 1961-78, significantly faster than the 25X1

Table 1
Central America: Investment Indicators, 1978

Percent

	Latin America	Central America	Costa Rica	Honduras	Nicaragua [a]	El Salvador	Guatemala
Gross domestic investment/GDP	25.4	22.5	23.4	27.7	27.2	26.1	21.6
Public investment/gross domestic investment	45.6 [b]	27.0	34.1	32.7 [c]	42.4	26.6	20.0
Direct foreign investment/gross domestic investment	1.4 [c]	5.0	5.7	2.4	2.0	2.9	9.1
Net external financing/gross domestic investment	9.1	18.0	30.6	28.3	30.2	23.5	12.4
Savings/GDP	23.1	16.8	19.7	15.1	11.1	13.6	10.3
Taxes/GDP	16.5 [d]	13.5	19.8	15.1	11.1	13.6	10.3
Outstanding public debt/GDP	NA	24.1	29.8	36.0	34.7	10.9	7.8

[a] Data are for 1977 or nearest available year because 1978 information reflects the beginning of revolutionary upheaval and its contractionary effects on most economic activity.
[b] Data are for 1974.
[c] Data are for 1977.
[d] Data are for 1975.

[redacted] 25X1

6.3-percent rate achieved by Latin America as a whole. El Salvador, Guatemala, and Nicaragua clustered around the region's average performance, while Costa Rica exhibited the most striking industrial growth 8.5 percent per year. Honduran industry, the least developed in the region, nonetheless expanded by a respectable 5.5 percent annually [redacted]

Manufacturing's impressive performance was directly attributable to the formation of the Central American Common Market (CACM) in 1960. The CACM eliminated intraregional tariffs and trade quotas on manufactured goods, established a common external tariff, and ensured barrier-free currency convertibility mechanisms that stimulated growth of regional trade and permitted economies of scale otherwise beyond the reach of small countries. As a result, intraregional trade boomed and by 1978 accounted for one-fifth of total international sales and absorbed virtually all the region's manufactured exports. At the same time, however, these countries had not developed products that would be competitive outside the protected common market. [redacted] 25X1

As in many LDCs, rapid economic growth was debt led, but plentiful foreign financing permitted Central American countries to increase foreign exchange reserves by $1.3 billion during 1970-78 according to official statistics. Regional current account deficits over the same period totaled $4.5 billion, or about 20 percent of export earnings, the same share as for Latin America as a whole. To cover the current account deficit and amortization requirements, Central America secured about $5.2 billion in medium- and long-term loans, of which slightly more than half

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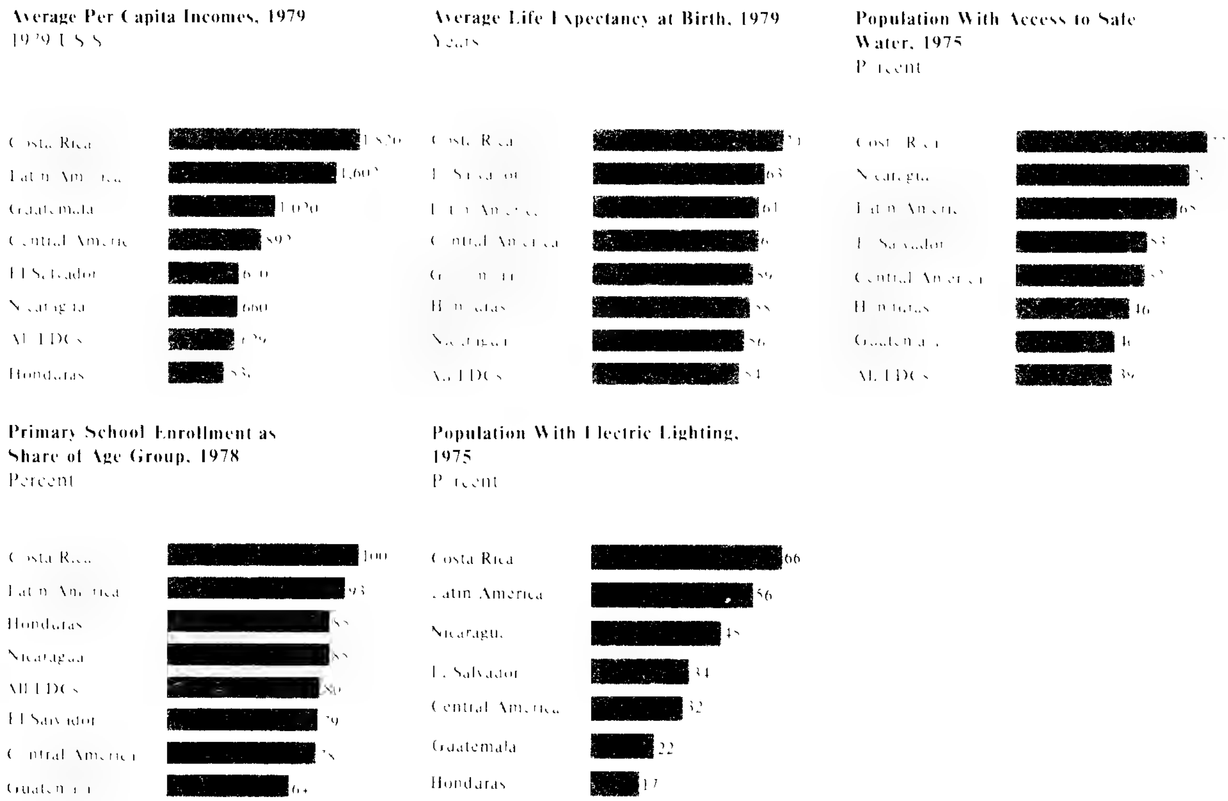
Figure 2
Central America: Living Standard Indicators



[redacted] 25X1

went to the public sector directly or were publicly guaranteed. Other sources of foreign exchange included net direct investment of $1.4 billion and short-term loans of $1.1 billion. [redacted] 25X1

As a result of frequent borrowing, Central America's external public debt reached slightly more than $4 billion by the end of 1978. On the basis of past financing patterns, we estimate that outstanding private debt was nearly as high. Nevertheless, debt service requirements remained manageable. According to UN information, foreign interest and principal payments consumed 11 percent of Central American export earnings during 1970-78, as compared to 23 percent for Latin America. Wide variation existed within Central America, however. Costa Rica's debt service ratio reached 20 percent, while Salvadoran and Guatemalan rates remained below 10 percent [redacted] 25X1

Figure 3
Central America: Agricultural Landholding, by Size, 1970

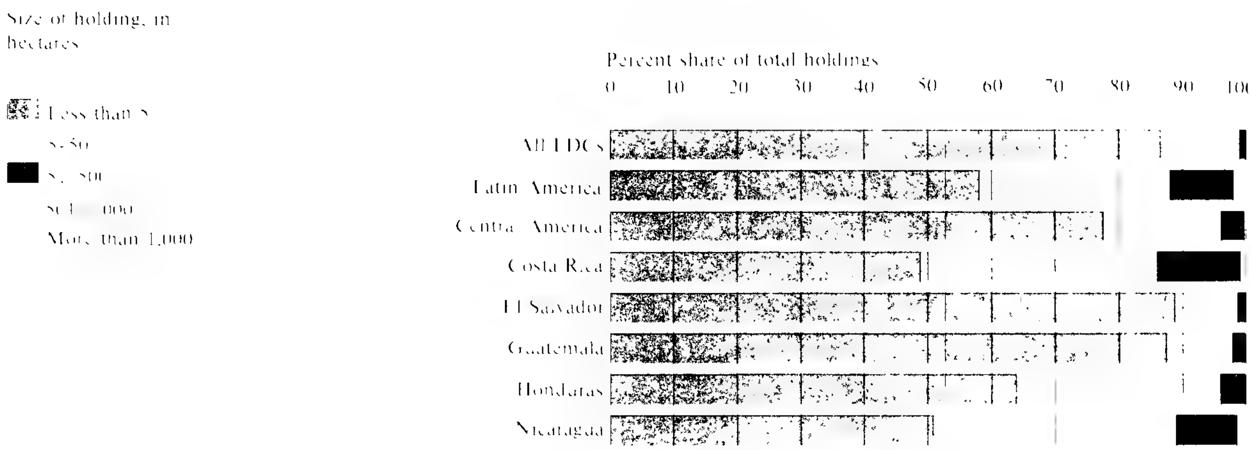


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Table 2
Central America: Foreign Financing Gap, 1970-78

Million US $

	Central America	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
Current account	−4,535	−1,721	551	−514	844	905
Trade balance	−3,673	1,356	−556	−701	556	504
Exports (f.o.b.)	24,512	5,119	5,189	6,834	3,293	4,077
Imports (c.i.f.)	28,185	6,475	5,745	7,535	3,849	4,581
Net services and transfers	862	−365	5	187	288	401
Amortization	1,796	746	224	279	238	309
Foreign financing gap	**−6,331**	**2,467**	**775**	**−793**	**1,082**	**1,214**
Foreign direct investment	1,381	402	156	652	63	108
Medium- and long-term loans	5,174	1,704	790	773	955	952
Private	2,231	701	269	325	464	472
Official	2,943	1,003	521	448	491	480
Net short-term capital (including errors and omissions)	1,115	496	49	3	232	335
Change in gross reserves	1,339	135	220	635	168	181

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Central American Development Strategies

Healthy private-sector investment formed the core of Central America's economic development before 1979. During most of the 1970s, for example, the private sector accounted for more than two-thirds of gross domestic investment. Total investment equaled roughly one-fourth of GDP, a level close to the strong Latin American average. Governmental roles in economic development were noticeably limited. Although government projects usually stressed development of utilities, transportation and communications networks, private investors occasionally built roads, utilities, and railroads needed to accommodate their businesses. Moreover, public construction of schools, hospitals, and similar facilities often was neglected. 25X1

Although domestic savings and taxes provided the bulk of investment capital, Central America relied on foreign funds to a greater extent than the rest of Latin America. Foreign lending and equity investment contributed nearly 20 percent of gross domestic investment in Central America during the 1970s, as compared to less than 10 percent in Latin America overall. Dependence on foreign capital partly stemmed from a relatively low Central American savings rate, attributable to the region's comparably backward economic development level. Tax rates also were somewhat lower. 25X1

Despite these broad similarities within the region, distinctive patterns of economic development emerged in individual Central American countries. 25X1

- ***Costa Rica.*** *Unusually strong government participation accompanied economic development. San Jose's sustained hefty investment in education, health, transportation, and communications pushed labor force skills, roads, and utilities toward standards prevailing in some developed countries - a policy that lured foreign investors. Government-driven development and social insurance programs proved expensive, however, and tax rates, by far the steepest in the region, were nearly double those in Guatemala and Nicaragua. Although Costa Rica's savings rate was the highest in Central America, San Jose relied heavily on foreign commercial banks to finance economic expansion and rapidly accumulated a large public foreign debt.* 25X1

- ***Honduras.*** *An ambitious government development program beginning in the mid-1970s boosted investment rates to the highest in the region by 1978. Tegucigalpa's efforts to overcome past neglect of transportation, communications, and social services came too late to quickly attract many international businesses, however, and the level of direct foreign investment remained the lowest in the region. To fund its large investment, Tegucigalpa boosted taxes and turned to foreign banks. As a result, by 1978 Honduran tax rates were the second highest in Central America and external public debt claimed the largest share of GDP in the region.* 25X1

- ***Nicaragua.*** *Managua also was a latecomer to economic development. Until the earthquake in 1972, investment rates were in line with Central American averages and most of gross domestic capital formation occurred in the private sector. This changed radically in the years following the earthquake, when large inflows of foreign aid were channeled into government investment and Managua's share of total investment more than doubled. The composition of government projects also shifted. Although construction of utilities, transportation, and communications networks retained predominance, investment in health, education, and public housing*

more than doubled. Generous foreign lending largely compensated for the country's declining direct foreign investment inflows and permitted Managua to carry out development plans while holding taxes down. This strategy rapidly added to the foreign public debt, however, and Nicaraguan debt obligations quickly surpassed those of Costa Rica in absolute terms. [redacted]

- ***El Salvador.*** *Strong investment by major industrialists and large landowners kept capital formation rates above the regional average. Government participation was lower only in Guatemala. San Salvador spent more than $2 for roads, bridges, and utilities for every dollar it directed toward social services. Because domestic savings rates were the lowest in Central America and foreign direct investment also was weak, El Salvador relied on foreign commercial banks for investment financing. Public external debt remained small, however, because the bulk of borrowing was private.* [redacted]

- ***Guatemala.*** *Its development strategy differed markedly from Costa Rica's. Total investment rates were similar, but Guatemala City played little role in investment decisions. Development of transportation and communications links was largely left to the private sector, and social service investment was neglected. As a result, the public foreign debt/GDP ratio was among the lowest in the developing world. At the same time, direct foreign investment accounted for more than 9 percent of gross domestic capital formation—nearly twice the regional average. Investors were attracted by the lowest taxes in Central America, low wages, and minimal bureaucratic redtape.* [redacted]

Shaken by Change: 1979-82

Regional economic growth fizzled in 1979 when the beginning of sustained insurgent activity coincided with dramatic deterioration in external terms of trade. In those countries plagued by the fighting—Nicaragua, El Salvador, and Guatemala—damage and losses directly detracted from economic activity. Throughout the region, the specter of instability darkened the investment climate and dampened foreign lending. Violence and guerrilla intimidation in the countryside reduced agricultural labor migration and cut into harvests. Manufacturing withered as intraregional commerce dropped precipitously. These problems were compounded by oil prices that more than doubled, softening world demand for agricultural commodities, and higher interest rates. [redacted]

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As a result of these factors, by the end of 1982 real economic activity, measured in US dollars, plunged nearly 20 percent from the 1979 peak, a drop of about one-third in per capita terms. Deterioration was the most severe in El Salvador and Nicaragua where output slid about 25 percent.[1] Throughout the region, governments struggled to cope with mounting economic chaos. Austerity programs designed to control inflation and mollify foreign lenders drained political support from those segments of society most squeezed by rising unemployment, higher taxes, and declining public expenditures on social services. [redacted]

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[1] Although Costa Rican economic activity registered a similar sharp decline, a large share was directly linked to the huge devaluation of the colon against the US dollar that took place over 1981-82; if measured in colones, GDP fell by 8 percent. [redacted]

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Effects of the Insurgency

Direct damage caused by the fighting was a major component in the economic downturn:

- In Nicaragua, damage and production losses associated with Somoza's overthrow reached $2 billion, according to World Bank estimates. Managua claims that anti-Sandinista insurgent activity in 1982 alone caused an additional $58 million in direct losses.

- In El Salvador, guerrilla attacks on crops, factories, roads, and bridges cost at least $600 million in direct damage and production losses from the escalation of the fighting in 1979 through 1982, according to US Embassy estimates.

- In Guatemala, attacks on economic targets were largely limited to sporadic destruction of nonproductive assets and periodic sabotage of the major oil pipeline. Nonetheless, we calculate that direct damage probably totaled about $20 million by the end of 1982.

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A more devastating effect of the violence, however, was the sharp drop in private investment that mirrored businessmen's fears of a worsening economic, military, and political situation. International Monetary Fund (IMF) reports show that for the region as a whole, domestic private investment volume plummeted about 75 percent during 1979-82 and foreign net direct investment fell similarly. The decline was steepest in El Salvador, where guerrilla threats successfully intimidated potential investors and reduced planting and harvesting. Even in countries not directly affected by insurgency, however, the proximity of trouble and weakening regional economic health cut deeply into investment.

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Struggling to sustain economic vitality in the midst of dwindling private investment, the government sector began to take a larger economic role. Consequently, the public share of total investment, previously limited to about 20 percent, reached more than 40 percent last year. Gross domestic investment dipped to less than 15 percent of GDP in 1982, as compared to nearly 25 percent in 1978.

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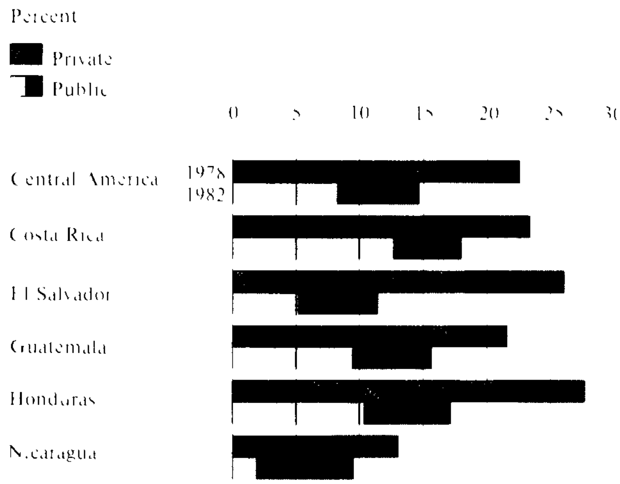
Figure 4
Central America: Gross Domestic Investment as a Share of GDP



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The insurgency also dealt a disastrous blow to CACM—already showing signs of stagnation because of the limited size of the regional market. According to official statistics, trade volume fell by about half during 1979-82 as instability disabled the economies of Nicaragua and El Salvador. The volume of Nicaraguan exports to CACM plunged by 75 percent, and Salvadoran sales fell by 50 percent as import restrictions and other obstacles to production depressed exports in these countries. In turn, the unavailability of raw materials from Nicaragua and El Salvador further reduced output throughout Central America. A large Costa Rican tuna exporter, for example, was forced to slash production when his longstanding Nicaraguan supplier of tomato paste closed.

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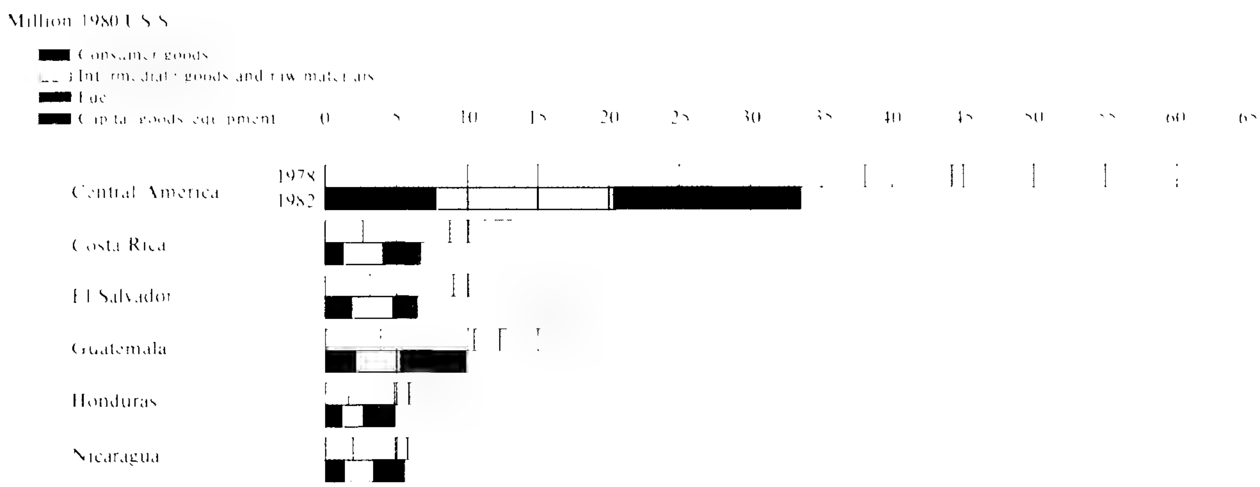
At the same time, uneven and poorly managed purchases led to massive financial arrearages within the region that choked off its commerce. Nicaragua's

Figure 5
Central America: Imports by Type, 1978 and 1982



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demand for imports surged in 1980 as Managua attempted to revive a war-ravaged economy, and its purchases from CACM—largely funded by Guatemalan credits—nearly tripled from 1979 levels. As the fighting heated up in El Salvador in 1980, real imports from CACM rose 15 percent because San Salvador boosted purchases of consumer goods in an effort to maintain living standards despite falling domestic production. Worsening balance-of-payments positions hindered these countries' ability to pay CACM suppliers, however, and we calculate that total arrearages to regional trading partners climbed to about $500 million by the end of 1982. Of these unpaid debts, Nicaragua owed about $300 million and El Salvador $75 million despite sharp drops in import purchases. Intraregional trade became snarled as countries adopted foreign currency controls, deposit requirements, and import restrictions that marked the end of two decades of vigorous CACM growth.

Foreign Economic Factors

Global conditions exacerbated Central American economic woes when careening commodity prices contributed to a doubling of the region's current account deficit during 1979-81 and forced deep cuts in imports needed to sustain economic activity. IMF and World Bank studies show that the Central American current account deficit topped $2 billion in 1981 following a 50-percent drop in real coffee prices and a near tripling of energy bills over the previous two years. The deficit was held to $1.5 billion in 1982 at the cost of a 30-percent cut in import volume that came on the heels of earlier, less drastic reductions. By the end of 1982, total import volume reached little more than half of 1978 levels. According to official data, imports of capital goods and raw materials—needed to maintain economic growth—were most severely restricted,

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Table 3
Central America: Foreign Financing Gap

Million US $

	1978	1979	1980	1981	1982
Current account	1,084	755	−1,566	2,069	−1,517
Trade balance	−594	431	−1,058	1,151	710
Exports (f.o.b.)	4,016	4,783	5,110	4,615	3,906
Coffee	1,586	1,777	1,689	1,328	1,290
Imports (c.i.f.)	4,610	5,214	6,168	5,765	4,616
Net services and transfers	490	−324	508	918	807
Amortization	357	510	454	842	684
Foreign financing gap	**1,441**	**−1,265**	**2,020**	**−2,911**	**−2,201**
Capital account	1,512	1,138	781	2,070	2,341
Foreign direct investment	186	187	165	189	148
Medium- and long-term loans	1,211	1,016	1,218	2,212	1,766
Official	576	614	1,113	1,475	1,429
Private	636	402	105	737	337
Net short-term capital (including errors and omissions)	115	65	−602	331	427
Change in gross reserves	71	127	−1,239	841	140

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while purchases of consumer goods, primarily for political reasons, maintained precrisis shares of total imports.

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The Central American countries were unable to meet soaring foreign financing needs without massive cuts in imports because the global monetary crunch tightened access to overseas commercial credit and sent interest rates skyrocketing. As longstanding links with commercial banks weakened, Central American countries stepped up appeals to official lenders for concessional aid. Official lending—mostly from multilateral agencies and Organization for Economic Cooperation and Development (OECD) sources—rose rapidly, and, according to the World Bank, accounted for three-fourths of new medium- and long-term loans disbursed during 1979-82. In the process, the external public debt of Central American countries more than doubled to about $10 billion. Nevertheless, the more than $6 billion secured from all sources was not enough to counter the effects of falling production, worsening terms of trade, and capital flight. The region's governments drew down foreign exchange reserves by $2 billion, leaving virtually no cushion against possible future economic shocks.

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Reversals in Key Productive Sectors

As in the past, agriculture drove overall economic activity; output in this sector declined by 18 percent during 1979-82 according to official statistics. Shortages of imported fertilizers, pesticides, and spare parts, low investment related to uncertainty about land reform, disruptions in the supply of migrant labor, low international commodity prices, and damage from insurgent activity all contributed to the slide. Deterioration was most pronounced in El Salvador and Nicaragua, where output in agriculture fell

Figure 6
Central America: External Public Debt Compared to GDP

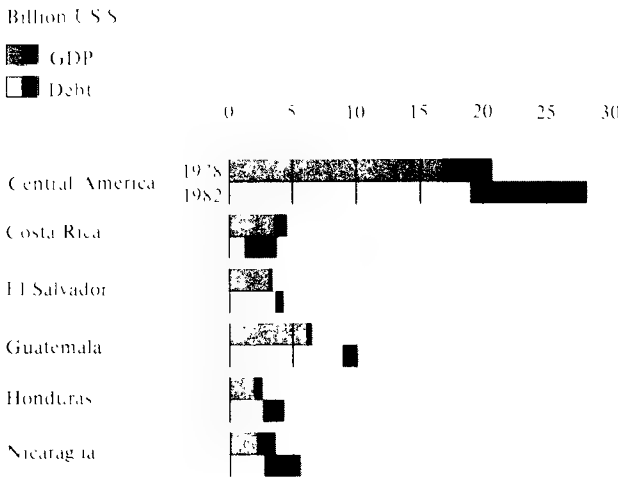

Table 4 *Million US $*
Central America: Sources of Foreign Official Loans, 1979-82

	Total	Multilateral Institutions	Bilateral Lenders	
			United States	Others
Central America	**4,631**	**1,598**	**751**	**2,282**
Costa Rica	619	295	77	247
El Salvador	1,117	302	334	481
Guatemala	493	318	71	103
Honduras	804	368	152	284
Nicaragua	1,599	315	117	1,167

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34 percent and 28 percent, respectively. Throughout the region, production of export crops suffered as farmers reverted to planting basic crops—corn, beans, and rice—that required lower investment, fewer imported inputs, and provided an ensured food supply.

Industry paralleled agricultural performance, and production dropped 20 percent as the CACM crumbled. As in agriculture, the falloff was most severe in El Salvador and Nicaragua. Large Guatemalan credits extended to these countries buoyed Guatemalan industrial production and the sector stayed intact. Domestic import substitution throughout the region only partially compensated for CACM's decline, and by 1982 the value of common market trade had shrunk to 20 percent of the value of the region's manufacturing sector, as compared to 30 percent in 1978. Attempts to export these products elsewhere in the world market generally were thwarted by the uncompetitive nature of long-protected industries.

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Output in other sectors dropped, and the structure of production shifted in response to shrinking overall economic performance:

- Activity in the once-vigorous construction sector slowed despite public-sector attempts to compensate for sharply reduced private building.
- Transactions in the financial sector declined as bad debts and foreign currency bottlenecks dampened banking activity and growing losses threatened the insurance industry.
- Retail and wholesale trade was hamstrung by shortages of imported consumer products and intermediate goods.
- Tourism, an important source of foreign exchange and jobs in the past, was strangled by threats of guerrilla violence.

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Government Actions and Popular Reactions

As foreign payments problems intensified, all governments except Nicaragua's adopted austerity programs, often to qualify for IMF and other aid. After much official floundering in 1981 and stiff resistance, austerity took hold in earnest the following year:

- Government spending in the region as a whole plunged about 25 percent in real terms. President Luis Alberto Monge acted decisively by slashing Costa Rica's expenditures by roughly 40 percent.

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Table 5
Central America: Economic Performance by Sector, 1982

Index: 1978=100

	Central America	Costa Rica [a]	El Salvador	Guatemala	Honduras	Nicaragua
Real GDP	**84**	**92**	**77**	**102**	**109**	**83**
Agriculture (real value)	82	96	66	98	103	72
Selected crops (volume)						
Coffee	107	122	92	109	119	97
Cotton	71	100	51	56	55	96
Sugar	91	95	75	106	101	66
Corn	113	142	82	119	143	107
Rice	99	74	107	110	144	128
Beans	106	114	88	132	86	98
Industry (real value)	80	90	69	99	104	71
Services (real value)	86	91	85	105	116	96

[a] Separate data for Costa Rica are shown in colones because the steep devaluation against the US dollar exaggerates economic decline compared to other countries. All regional data are measured in US dollars.

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- Despite the growing importance of public-sector investment, these capital outlays slid 30 percent because governments could no longer afford to finance many development projects. In Honduras, the share of the budget allocated to investment was halved, and the government-funded development program in effect since the mid-1970s slowed sharply.

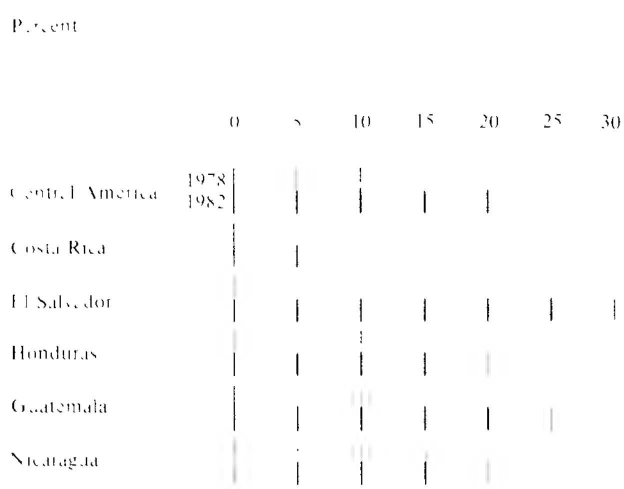
- Governments boosted taxes, but faltering economic activity kept a lid on revenues. The ratio of tax receipts to national incomes remained roughly constant, except in Nicaragua, where this ratio doubled from prewar levels.

- Domestic credit expansion was curtailed, and the private sector shouldered more than its share of the monetary burden. In all countries except Nicaragua, credit to businesses declined by an average of about 20 percent while public-sector credit stayed even with inflation. In Nicaragua, we estimate that credit to the private sector slowed to a token trickle in keeping with the Sandinistas' goal of squeezing out the middle class.

- All countries effectively devalued their currencies, although only Costa Rica did so across the board through a sharp devaluation of the colon during 1982-83. Elsewhere, most governments sharply limited the types of transactions made at overvalued official rates and forced increasing numbers of currency purchases onto free or parallel rate markets.

- Public-sector work forces were pared everywhere — except in Nicaragua, whose public sector ballooned from about 15 percent of GDP in 1978 to more than 40 percent by last year—and wage increases lagged inflation rates. In Honduras, press reports indicate that about 10,000 people were cut from the public payroll in 1982. 25X1

Figure 7
Central America: Unemployment Rates



According to press and Embassy reports, worsening economic conditions added an element of instability to an already volatile regional political situation. Distress cut across all income levels and segments of the population. Middle and upper classes were pinched by rising taxes and growing bankruptcies. Lower classes suffered from unemployment that we estimate reached nearly 25 percent of the region's work force in 1982 and from government cuts in social services. Popular reaction to these problems differed markedly by country and, indeed, by event within the same country:

- In Costa Rica, Monge enjoyed strong popular support in his early efforts to end the financial excesses of the Carazo administration. Nevertheless, according to press reports, popular dissatisfaction forced the government to slow the implementation of austerity measures such as utility rate increases and wage ceilings as business failures increased, unemployment reached unprecedented levels, and intractable inflation, combined with stagnant wages, cut private consumption sharply.

- In El Salvador, widespread resentment over the insurgent-inflicted damage to living standards partly inspired the large voter turnout in the March 1982 elections, according to US Embassy reports. Popular support for the government ebbed, however, when renewed insurgent violence in the second half of the year demonstrated the military's inability to defeat the guerrillas or to defend key electrical, industrial, and agricultural targets.

- In Guatemala, discord among various factions of the powerful private sector and within the government's economic cabinet stymied efforts to adopt new, austere economic policies needed to secure new IMF aid. Although many elements in the private sector believed austerity was necessary, if bitter, medicine, opposition from conservative businessmen and the Central Bank President to higher taxes and interest rates delayed the institution of a much-needed IMF program.

- In Honduras, the government met some resistance to planned austerity measures, but on balance we judge that economic hardships did not translate into much, if any, decline in the Suazo government's popular support. Slippage occurred in austerity targets when the Honduran Congress failed to pass a wide-ranging tariff reform measure designed to increase revenues substantially. Nevertheless, the administration's overall fortitude in dealing forthrightly with economic issues bolstered popular support.

- In Nicaragua, worsening economic troubles, including shortages of consumer goods, business failures, and the government's increasingly hostile posture against the private sector further sapped support from the middle and upper classes. Embassy and press reports cited mounting evidence of dissatisfaction among the lower classes, which were hurt by higher prices, scarcities of basic goods, and rising unemployment. Internal opposition to the regime remained weak and poorly organized, however, and the Sandinistas retained their mass base of support, particularly in urban areas. By portraying the United States as the main cause of Nicaragua's problems, the regime attempted to rally domestic support, suppress the opposition, and explain away economic hardships to most Nicaraguans.

Grim Prospects: 1983-84

Although world commodity demand and prices and foreign aid will be important, we believe insurgent activity and the associated climate of uncertainty will be the most critical factors influencing Central American regional economic performance during 1983-84.[4] Agricultural export earnings and foreign aid receipts largely will determine the availability of desperately needed foreign exchange, but business and government investment decisions—colored by guerrilla actions—will direct the course of economic development. [redacted]

Recognizing the relative magnitude of these variables, we analyzed likely economic performance under three scenarios for insurgent activity. In each case, we projected the economic performance that would occur if there were no major and unforeseen changes in existing foreign aid and other financial patterns and in world commodity price trends. Also, we selected theoretical economic growth targets consistent with averting further regional decline and then calculated how much foreign funding would be necessary to achieve these goals.[5] Thus, for 1983 we calculated financial needs on the basis of no growth in national output—the best performance we felt possible. For 1984 we targeted a 3-percent expansion in output—modest in a historical context but formidable in the current environment—that would represent holding per capita incomes steady for the first time since the regional turmoil began in 1979. To make our calculations, we used simple national accounting models that assumed no change in the violence, and then we adjusted the data to reflect broad changes in the security situation. [redacted]

The scenarios that we examined were:

Case I. Guerrilla activity continues near its current level. Despite the probable ebbs and flows in the fighting, no significant change takes place in the balance between insurgent and military forces throughout the region. Although changes in governments may occur, they are not disruptive.

Case II. The military situation shifts markedly in favor of the insurgents in El Salvador and possibly in Guatemala and Nicaragua. Subversive activity becomes more widespread in Honduras and Costa Rica.

Case III. Military forces achieve decisive victories in El Salvador, Guatemala, and Nicaragua. Terrorist threats fade in Honduras and Costa Rica.

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Subject to these assumptions and conditions, we then considered—in broad terms—the plausibility of the region receiving the calculated financing and the related impact on actual growth prospects. [redacted] 25X1

Common Constraints

In all three scenarios, we concluded that, despite brightening prospects for the international economy, lower world interest rates and oil prices, apparent progress on regional austerity programs, and fairly generous foreign aid projections, Central America probably will be unable to achieve dramatic economic improvement during the next few years. Regardless of developments on the military front, certain insurmountable factors will constrain economic activity:

- Even if global economic recovery is stronger than generally expected, the spectacular surge in commodity prices needed to overcome the region's foreign exchange difficulties is unlikely to occur.[7]
- Absent large aid disbursements from major official donors, foreign funding is unlikely to grow enough to boost imports significantly.
- Potentially positive external influences, such as inclusion in the Caribbean Basin Initiative, under the best of circumstances will take several years to reach maximum effectiveness.

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[4] We recognize that the relative importance of global economic and security conditions varies somewhat among countries in Central America. [redacted]

[5] For reasons already detailed in this paper, we assumed that official aid—rather than private sources—would have to make up most, if not all, of this support. [redacted]

[6] For a further description of the sources and methodologies used in developing these cases as well as discussions of our data sources, see the appendix [redacted]

[7] For a further description of our commodity price series, see the appendix [redacted]

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- Production in the region's manufacturing sectors will remain 40 to 50 percent below capacity until the existing tangle of arrearages is straightened out. In addition, depleted industrial capital stock and inventories will take time to correct.

- Uncertainty over prospects for land reform and past neglect of fields and equipment will hold down agricultural production.

- The region's beleaguered private sector will not soon provide a firm foundation for renewed economic growth. Several years of peace and stability would be needed before private investment could rebound.

- The shrunken tax base will limit governments' ability to raise funds to finance public-sector growth. [redacted]

Case I: No Critical Change in Military and Political Conditions

We judge this case to be the most likely through the short term at least. Military developments in El Salvador, probably the most reliable barometer of upheaval in the region, continue to appear essentially stalemated. The insurgency in Nicaragua, another potential harbinger of major regional change, appears incapable of threatening the Sandinistas' hold on power any time soon. Although we cannot rule out sudden developments such as coups or assassinations that would modify the current political situation, we believe that such events would not prove disruptive for any length of time unless they were accompanied by a critical shift in the military balance. [redacted]

In this scenario, the same factors that derailed economic production during 1979-82 will preclude recovery:

- Direct damage and losses from the fighting will continue to plague the Salvadoran, Nicaraguan, and Guatemalan economies. In El Salvador, guerrilla attacks on economic targets are becoming more intense, according to press reports, with increasing violence affecting peasant producers of basic grains. Managua recently announced that losses from counterinsurgent attacks have totaled $110 million over the past two years. In Guatemala, although the insurgency does not pose a threat to the government, Embassy reports show an increase in guerrilla activity—perhaps capitalizing on the unstable political climate—since the coup in August.

- The overall investment and commercial lending climate will not brighten significantly even in countries not directly affected by the fighting. Widespread press reports of Nicaragua's increasing threats to Costa Rica and Honduras probably will prevent or postpone many fledgling investment plans. Meanwhile, prospects for new foreign commercial lending in the region deteriorated recently when a proposed $100 million commercial bank loan to Guatemala the only loan under active consideration in the area—was rejected.

- Substantial Nicaraguan and Salvadoran arrearages will continue to prevent a resurgence of CACM trade and the revival of the region's manufacturing sector. Although individual countries have demonstrated a willingness to discuss this problem and to work out tentative reschedulings, Managua's extremely difficult financial situation and inability to pay its $300 million debt continues to block progress. The ink was barely dry on a recent rescheduling accord between Nicaragua and Costa Rica before Managua failed to meet the new terms.

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- Unless eased by unexpected foreign aid inflows, the balance-of-payments bind will continue to limit imports, which, in turn, will further depress economic activity. At current financing levels, we project that regional import volume in 1983 will fall by roughly 20 percent below last year's low levels. Imported raw materials, intermediate goods, and spare parts will be in particularly short supply. Consumer goods, relatively protected from cuts in the past, probably will face sharp reductions [redacted]

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The level of foreign financial support needed merely to stabilize these economies would be sizable. We calculate that the region would need a total of about $2.5 billion in 1983 just to avert further economic slippage even if commodity prices recover somewhat. To reach 3-percent growth next year, nearly $3 billion would be required. [redacted]

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Table 6
Central America: Projected Foreign Financing Gap, 1983-84

	1983 (Case I)		1984 (Case I)	
	0-Percent GDP Growth	3- to 5-Percent GDP Decline	3-Percent GDP Growth (Following 0-Percent Growth in 1983)	3- to 5-Percent GDP Decline (Following 3- to 5-Percent Decline in 1983)
Current account	-2,003	-1,265	−2,382	−1,193
Trade balance	−743	5	1,087	102
Exports (f.o.b.)	4,076	4,076	4,228	4,228
Imports (c.i.f.)	4,819	4,081	5,315	4,126
Net services and transfers	1,260	1,260	-1,295	−1,295
Amortization	537	537	609	609
Foreign financing gap	**−2,540**	**−1,802**	**−2,991**	**1,802** [b]

[a] Assumes various economic growth rates, no change in the security conditions, and moderate commodity prices. Export earnings could fall slightly from those shown if the tentative recovery in commodity prices now apparently under way fails to develop.
[b] Assumes no change in current foreign financing levels.

[redacted] 25X1

Because foreign exchange reserves are nearly depleted and because we judge that prospects for commercial lending are virtually nil, foreign aid will determine actual import levels and growth rates. Aid now anticipated from official sources falls short of these requirements, however. We estimate that Central American countries will receive about $1.8 billion in hard currency assistance this year, of which about $600 million will come from multilateral lenders, including the IMF. Bilateral sources are expected to contribute $1.2 billion, including roughly $450 million from the United States, the largest individual lender. [redacted]

We doubt that aid levels will increase significantly in 1984. Even if Central American countries manage to adhere to austerity programs necessary for IMF and other multilateral assistance, these agencies probably will continue to face shortages of lendable funds. The Central American Bank for Economic Integration, for example, a small but important source of aid in the past, by its own account is on the verge of insolvency. Most bilateral lenders probably will continue to offer only small aid packages until the regional turmoil is resolved. [redacted]

At these aid levels, we calculate that economic output in the region as a whole will fall this year and next, although prospects are brighter for Costa Rica and Honduras, where further large declines may be avoided. Nevertheless, political pressures will mount everywhere in the wake of rising unemployment, increasing bankruptcies, and shrinking consumption:

- Deterioration will be most pronounced in **El Salvador,** where another 5-percent loss in economic output is likely each year, furthering the insurgents' goal of crippling the economy. Although steadily worsening economic conditions may detract from popular support for the guerrillas, we believe there is a serious risk that the government's longstanding inability to arrest the economic slide will work to the advantage of the extreme right in the upcoming elections.

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Central American Aid Prospects

We estimate that foreign aid disbursements in 1983 will fall $500-700 million short of the $2.5 billion needed to prevent further economic slippage.[a] *Compliance with the terms of IMF austerity programs is becoming more difficult, and pressure is mounting on traditional bilateral lenders to increase assistance accordingly. We judge that aid from official bilateral sources will not grow significantly at least over the near term, however, because most lenders—largely for domestic political reasons—are reluctant to increase commitments to the troubled region:*

- ***Costa Rica*** *probably will receive about $450 million in foreign aid in 1983. Some $200 million will come from multilateral sources, including $100 million from a one-year IMF standby agreement. The United States, the largest individual bilateral lender, will supply about $150 million, mostly in Economic Support Funds (ESF). Other bilateral aid— largely agricultural supplier credits and project assistance—will come from West European countries and Canada. In addition, Mexico and Venezuela together provide concessionary financing on oil purchases and small supplier credits for other items.*

- ***El Salvador*** *is slated to receive approximately $475 million in foreign aid this year. Multilateral assistance includes $35 million from combined IMF standby/compensatory fund facility loans and $85 million from the Inter-American Development Bank. US economic aid of about $200 million—in development assistance, ESF, and other programs—leads other bilateral lending by far. Venezuela, the second-largest individual lender, is providing about $60 million in supplier credits in addition to partial oil financing. Colombia is a smaller source of credits, and, according to US Embassy reports, Bonn and Tokyo are considering modest new aid packages.*

- ***Guatemala*** *probably will collect about $200 million in aid this year, much of it from multilateral sources. Some $40 million probably will be disbursed under a new $125 million, one-year IMF standby accord. In addition, the Inter-American Development Bank is expected to provide about $55 million. US economic assistance of about $60 million will be closely trailed by Venezuelan credits, mostly for oil financing.*

- ***Honduras*** *probably will receive approximately $300 million in aid this year. Disbursements under an IMF standby agreement will total about $70 million, and an additional $100 million is likely from other multilateral sources. US loans under various assistance programs will reach about $45 million, and other bilateral aid—West European programs and Mexican-Venezuelan oil financing—will total another $75 million.*

- ***Nicaragua*** *probably will collect about $400 million in hard currency loans and supplier credits this year. Multilateral assistance is limited to small project loans because Managua continues to reject IMF austerity conditions. Mexico, traditionally Nicaragua's largest individual lender, recently tightened oil financing terms considerably, but we expect that Mexican aid still will come close to the $145 million in oil financing and supplier credits provided last year. Managua has announced 1983 pledges from other Western sources—including France, Spain, Scandinavia, and South America. In addition, Nicaragua is stepping up appeals to Communist countries, but we believe these sources will continue to avoid disbursing hard currency aid. Although Managua has announced $240 million in supplier credits and technical assistance from CEMA countries for 1983, we believe, in keeping with past trends, that only a small portion of this aid will be disbursed.* 25X1

[a] *Despite the critical importance of foreign aid, we cannot project receipts with precision because disbursements—often driven by political factors—are subject to sudden change even in those instances when commitments appear reasonably firm.* 25X1

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- Economic performance probably will be similarly weak in **Guatemala,** where we expect a decline of 4 percent this year. A bottoming out is possible in 1984 if the government manages to stick to the terms of the new IMF program, but growing political strains are making that course less likely. Mejia already has scaled back the contentious value-added tax in response to pressure from far right elements in the military and business communities. The resultant budget squeeze will force deeper cuts in social services and public works programs, according to the US Embassy, if Guatemala is to stay within IMF credit ceilings. Growing economic hardship probably will have the most pronounced effect on the poor and will provide fresher opportunities for exploitation by the guerrillas.

- The faltering economy in **Nicaragua** probably will slip roughly 3 to 5 percent each year, and we believe Managua will search for ways to protect living standards of the lower class, the Sandinistas' core of popular support. We expect that taxes on the middle class will increase and that property confiscations will be speeded up. For example, to shore up popular support, the government recently hastened the distribution of nationalized farmland to peasants in areas affected by the counterinsurgency.

- In **Honduras,** economic decline of about 2 percent is likely this year, and constant year-to-year output might be reached in 1984 if Tegucigalpa continues to adhere to rigorous IMF-mandated austerity. Nevertheless, popular support for the government—now bolstered by the perceived threat from Nicaragua and the expectation that Suazo will attract large amounts of US aid—could weaken, and labor unrest and popular agitation could grow in the face of expected increases in bankruptcies and unemployment. Moreover, peasant land invasions could rise because the government is short of funds for legal expropriation of land.

- In **Costa Rica,** projected economic decline of about 2 percent this year and stagnation—at best—in 1984 will test Monge's willingess and ability to adhere to the austerity measures crucial to undergird long-term economic recovery. Recent widespread protests prompted the government to rescind planned utility rate hikes, and Monge's substantial public support is eroding. Not surprisingly, next year's budget proposal, currently under legislative consideration, contains inflationary spending measures that could torpedo the IMF program and reverse the encouraging progress on debt rescheduling made with foreign creditors. [redacted] 25X1

Case II: Marked Insurgent Success

Regional security could deteriorate dramatically if Managua and Havana significantly stepped up support for Salvadoran insurgents. This scenario also postulates increases in insurgent activity in Nicaragua, growing terrorism in Honduras and Costa Rica, and intensified Guatemalan rebel activity. [redacted] 25X1

Although it is impossible to predict the regional military and political outcome of such developments, the economic impact would be clear:

- Production losses directly attributable to the fighting would skyrocket in El Salvador, Nicaragua, and Guatemala and could become a factor in economic decline in Costa Rica and Honduras.

- Total investment would plunge as increased military spending strained the shrinking tax base and soaked up funds previously allocated to public development projects. Net private investment at home, already wobbling, would cease.

- The flight of capital and manpower would surge as investors smuggled assets out of the troubled region. In addition to peasants fleeing the violence, emigration of skilled labor and managers needed to accomplish any economic turnaround also would rise. Expected increases in refugee flows would severely strain resources of international relief agencies and the recipient economies themselves.[8]

[8] The latest figures indicate that more than 180,000 Central Americans are receiving assistance in foreign countries, principally Honduras, Mexico, and Costa Rica, but reports vary and the total number of refugees may be much larger. [redacted] estimates that there are only 30,000 to 40,000 refugees in Mexico, although a paper discussed at a recent symposium suggests that the number may be as high as 250,000. Throughout the region an additional 740,000 are internally displaced, and larger numbers of additional refugees may be uncounted. [redacted] 25X1 25X1 25X1

- Ironically, the current account of the balance of payments could improve somewhat as the result of possible steep reductions in imports but the ensuing economic decline would be sizable. Although need for imported food, medical supplies, and other basic goods could grow, demand for intermediate imports could again slacken considerably as the region adopted a war footing. In the countries most severely affected, total imports could follow the pattern set during Somoza's overthrow when such purchases were halved. [redacted]

Aggregate economic losses would be impossible to calculate and would depend on the scope of guerrilla victories. The climate of increased violence would, however, cause distinctive shifts in production patterns. In agriculture, cultivation of export crops would wane and farmers—and, indeed, others—would shift to subsistence crops. Regional commerce would break down almost completely, and manufacturing sectors probably would remain active only to the extent that factories could be retooled to produce defense materials.

In these bleak circumstances, foreign aid needed to ward off economic decline would substantially exceed the $2.5 billion projected in Case I. Moreover, no amount of foreign aid would do more than prop up imports and living standards. Because besieged governments would be hard pressed to contain investor panic or channel aid into productive investments, no likely amount of foreign aid could spark economic growth. [redacted]

Nevertheless, governments battling vigorous insurgencies would seek foreign aid with stepped-up urgency as a means to slow the guerrilla momentum. Because compliance with austerity programs would become increasingly difficult—both from a political and economic perspective—new lending from multilateral sources would be highly unlikely. Countries would turn their appeals toward bilateral lenders, particularly the United States. [redacted]

Case III: Decisive Military Victories

Should Cuban and Nicaraguan support for Salvadoran insurgents cease entirely, sustainable guerrilla activity in El Salvador eventually would fade as supplies ran down. This scenario further postulates that insurgent activity in Nicaragua and Guatemala also ends. [redacted] 25X1

Even if the improvement in the security climate were dramatic, however, the region's economies would take time to rebound proportionately:

- Guerrilla damage already inflicted would be costly and time consuming to repair. In El Salvador and Nicaragua, few damaged bridges, railroads, electric power installations, and other facilities have been repaired. Moreover, many of the repairs made to vital facilities have been improvised because expensive imported spare parts were unavailable or because further guerrilla attacks were anticipated. 25X1 25X1

- Foreign and domestic lender and investor confidence would be slow to revive even under optimum security conditions. [redacted] factoring in the US-sponsored incentives under the Caribbean Basin Initiative, we believe several years of peace and political stability would have to pass before much new private capital would flow into Central America. Moreover, local businessmen, in our view, would want to better utilize existing capacity before considering new undertakings. 25X1 25X1

- Governments would be largely unable to compensate for soft private-sector investment. Although substantially reduced defense needs could free up funds for public investment purposes, interest on public debt and expected wage hikes for government employees could eat up most of these funds. Because the tax base probably would expand only slowly, overall government spending could not rise sharply without threatening existing IMF accords. 25X1

- Demands for wage hikes would add to production costs throughout the region as labor struggled to regain former living standards. Unless import controls remained in place, pent-up consumer demand would compete with producers' needs for imports. 25X1

- Low inventories, cannibalized equipment, and shortages of financing would constrain manufacturing throughout the region. The pent-up import demand for this sector probably could not be satisfied for several years. Before regional trade in manufactures could again become a key component of economic growth, overdue debt to Guatemala and Costa Rica would have to be rescheduled, import quotas rescinded, and barriers to currency convertibility lowered.

- Lingering uncertainties about prospects for agrarian reform would constrain agricultural output in El Salvador, Nicaragua, and, to a lesser extent, in Guatemala and Honduras long after the fighting stopped. Despite this problem, we would expect to see substantial return to the cultivation of export crops and an associated, and probably unfilled, upsurge in demand for imported pesticides, fertilizers, and spare parts for farm machinery. The migrant labor situation would return to normal only slowly, contingent on free and safe movement, and resolution of land reform issues and currency convertibility problems. [redacted]

Because the capital-starved region initially would be unable to generate enough foreign exchange earnings to finance import demand, large amounts of foreign aid would be needed for several years. We estimate that growing import demand would boost official foreign aid needs beyond the $2.5-3.0 billion calculated in Case I until foreign private investment and lending began in earnest. We judge that private-sector activity and business confidence would recover faster and become self-sustaining sooner in the presence of adequate sums of foreign aid [redacted]

Should the security climate improve, we believe somewhat more foreign assistance might become available than would be disbursed in our first two scenarios. Multilateral institutions might provide more funds, particularly if Nicaragua reconsidered its longstanding opposition to an IMF stabilization program. At the same time, depending on the thrust of Central American political developments, we believe bilateral lenders might step up aid programs substantially [redacted]

If foreign aid receipts fell substantially short of requirements, however, there would be a high risk that economic recovery would be jolted. Keen competition for scarce imports could set off an inflationary spiral that would be difficult to control. Unmet consumer expectations could translate into intractable labor problems that would depress productivity. Undoubtedly, governments would be tempted to deviate from stabilization programs even though such action could jeopardize multilateral aid and compound economic difficulties. In these circumstances, net new foreign commercial lending would disappear and business confidence would remain weak. [redacted] 25X1

Long-Term Costs of Prolonged Insurgency

If insurgent activity drags on into mid-decade, the costs of eventual economic reconstruction would soar. The longer the fighting continues, the more damage would be done to farms, factories, transportation networks, and utilities, and the steeper would be the final repair bill. Private capital stock, already neglected, would depreciate further. 25X1 Businessmen who have found ingenious ways to move their assets out of the region would have little reason to stay, and the drain of managerial and technical talent would be difficult to reverse [redacted] 25X1

The longer the battlefield is the arena for settling conflicts, the smaller the eventual role of the private sector would be in rebuilding the economies. Governments—working with minimal domestic capital resources, a depleted tax base, and generally lacking the skills found in the entrepreneurial class would assume the key role in economic decision making. 25X1 This major departure from the private-sector led growth path of the 1960s and 1970s probably would result in much slower growth, reduced access to private foreign capital, and a chronic demand for foreign aid [redacted] 25X1

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Implications for the United States

Economic aid will become an increasingly important feature in US–Central American relations in the coming years. Not only would continuing economic turmoil prompt an increasing flow of refugees and aggravate the already volatile political and military balance in a region vital to US security interests, but the Central American countries would petition Washington for aid with increasing urgency. We expect weakening resolve to stick to tightening austerity measures to jeopardize IMF and other multilateral funding. Central American appeals to other traditional bilateral lenders would be unlikely to meet with much success until the military conflicts are resolved and the political situation normalized. Indeed, all of our scenarios forecast a large gap between aid needs and likely receipts, a situation that would cause continuing regional economic decline. [redacted] 25X1
[redacted] 25X1

Although the broader implications of further economic deterioration in Central America would be serious, the direct financial costs to the United States would be relatively small. US private investment in the region currently totals less than $800 million, according to Commerce Department estimates. Of that investment, more than half of it is concentrated in Costa Rica and Guatemala. US trade with Central America, which has been declining steadily since 1979, fell to about $1.4 billion in each direction in 1982. US trade is distributed about evenly among all countries except Nicaragua, where it is substantially lower. Agricultural commodities readily available elsewhere on world markets account for the lion's share of US purchases from Central America. US exports include insecticides, herbicides, fertilizers, grains, motor vehicle parts, petroleum products, medical supplies, and unsophisticated electrical machinery. Because of continuing problems with overdue accounts, many US exporters authorize new shipments to the countries only when payment is guaranteed in advance. Although a large chunk of Central America's commercial debt is held by US banks, the region's outstanding debt to these banks is dwarfed by that of other Latin American countries. [redacted] 25X1
[redacted] 25X1

Appendix

Methodological Notes on Economic Forecasts

This paper aggregates information presented in our earlier appraisals of economic developments in individual Central American countries. [redacted]

At the heart of the projections in this paper are simple national accounting models to which we applied various assumptions concerning growth and exports to determine likely import and financing needs. To deal with uncertainties concerning world market conditions, we derived two different commodity price sets from historical data. [redacted] Moreover, for our first pass through the data, we also assumed that security conditions did not change much. We then inspected the completed financial projections to determine—in a broad sense—their sensitivity to security factors. This bracketing procedure provides the basis for the discussion of the three cases in the text and the data shown in table 6. [redacted]

Baseline Data

[redacted]

- ***Foreign Trade.*** Estimates were based on official statistics as reported by the US Embassy, the US Department of Agriculture, and the IMF.

- ***Foreign Debt.*** We relied on CIA estimates—[redacted]—for our total debt figures. We also used IMF estimates of medium- and long-term public and publicly guaranteed external debt. Debt-service requirements were drawn from official data supplied to the IMF and the US Embassy and reflect IMF projections for debt relief on publicly guaranteed debt.

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- ***Agricultural Production.*** Our estimates and projections were based largely on field reporting by the US Department of Agriculture. [redacted]

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The Projections

Our projections of foreign aid requirements for 1983-84 were calculated as the financing needed to close a projected foreign financial gap associated with a particular assumed economic growth and the related—and determinable—imports. Under this approach, the financial gap was calculated as:

$$FG = (I - E) - ST + A$$

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where FG equals the financial gap, I equals import expenditures, E equals export earnings, ST equals net services and transfers, and A equals amortization of medium- and long-term debt. [redacted]

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Exports of primary products—such as bananas, beef, coffee, lead, lumber, shellfish, silver, sugar, and zinc—were calculated as the product of projected volumes (based on a variety of open sources) and commodity prices (derived from historical series). The value of other exports, mostly manufactured goods, was forecast to stagnate during 1983 and 1984 because of the continued disruption of intraregional trade and inherent lags in increased exports, even if economic recovery in the OECD countries is stronger than we anticipate. [redacted]

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Table 7

Central America: Projected Foreign Financing Gap, by Country, 1983-84 [a]

	1983 (Case I)		1984 (Case I)	
Costa Rica	0-Percent GDP Growth	2-Percent GDP Decline	3-Percent GDP Growth (Following 0-Percent Growth in 1983)	3- to 5-Percent GDP Decline (Following 2-Percent Decline in 1983)
Current account	−493	−340	−582	−328
Trade balance	22	175	−27	227
Exports (f.o.b.)	951	951	998	998
Imports (c.i.f.)	929	776	1,025	771
Net services and transfers	−515	−515	−555	−555
Amortization	122	122	134	134
Foreign financing gap	**−615**	**−462**	**−716**	**−462**
El Salvador	0-Percent GDP Growth	5-Percent GDP Decline	3-Percent GDP Growth (Following 0-Percent Growth in 1983)	5-Percent GDP Decline (Following 5-Percent Decline in 1983)
Current account	−400	−350	−400	−325
Trade balance	−235	−185	−300	−225
Exports (f.o.b.)	740	740	800	800
Imports (c.i.f.)	975	925	1,100	1,025
Net services and transfers	−165	−165	−100	−100
Amortization	125	125	150	150
Foreign financing gap	**−525**	**−475**	**−550**	**−475**
Guatemala	0-Percent GDP Growth	4-Percent GDP Decline	3-Percent GDP Growth (Following 0-Percent Growth in 1983)	3- to 5-Percent GDP Decline (Following 4-Percent Decline in 1983)
Current account	−295	−15	−410	0
Trade balance	−195	85	−310	100
Exports (f.o.b.)	1,205	1,205	1,220	1,220
Imports (c.i.f.)	1,400	1,120	1,530	1,120
Net services and transfers	−100	−100	−100	−100
Amortization	90	90	105	105
Foreign financing gap	**−385**	**−105**	**−515**	**−105**
Honduras	0-Percent GDP Growth	2-Percent GDP Decline	3-Percent GDP Growth (Following 0-Percent Growth in 1983)	3- to 5-Percent GDP Decline (Following 2-Percent Decline in 1983)
Current account	−270	−250	−330	−240
Trade balance	−30	−10	−70	20
Exports (f.o.b.)	680	680	710	710
Imports (c.i.f.)	710	690	780	690
Net services and transfers	−240	−240	−260	−260
Amortization	110	110	120	120
Foreign financing gap	**−380**	**−360**	**−450**	**−360**
Nicaragua	0-Percent GDP Growth	3-Percent GDP Decline	3-Percent GDP Growth (Following 0-Percent Growth in 1983)	3- to 5-Percent GDP Decline (Following 3-Percent Decline in 1983)
Current account	−545	−310	−660	−300
Trade balance	−305	−70	−380	−20
Exports (f.o.b.)	500	500	500	500
Imports (c.i.f.)	805	570	880	520
Net services and transfers	−240	−240	−280	−280
Amortization	90	90	100	100
Foreign financing gap	**−635**	**−400**	**−760**	**−400**

[a] Assumes various economic growth rates, no change in security conditions, and moderate commodity prices.

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For 1984, commodity export volumes generally were projected to increase slightly. The reasons for these changes varied by country and are presented in appendixes to the individual reports.

Two different commodity price scenarios were derived from regional export prices since 1979. One series projects commodity prices continuing at the 1982 level through 1984; this results—on balance—in a low price set. The other series is based on average annual prices during 1980-82 and yields a moderately higher price set. In keeping with CIA and other commodity analysts' price expectations for global markets based on the OECD business cycle and anticipated market developments, we did not apply a high price series. Because the net effect of the low and moderate price series on total export earnings is only about 8 to 10 percent, for the sake of brevity we discussed only the moderate price scenario in the text. Full detail can be found in the country papers.

Imports were derived by applying import price increase estimates to the real imports we calculated as necessary to support our various assumptions about economic activity. Real import aggregates were linked with economic growth using incremental elasticity formulas that varied by country.

Net services and transfers consisted primarily of profit remittances and interest obligations on foreign debt. Total interest payments for 1983-84 were projected based on the scheduled interest payments on public and publicly guaranteed debt reported to the IMF and on our estimate of 1982 interest paid on private debt, which, for lack of further data, we assumed remained the same for 1983-84. Freight and insurance payments were projected as a constant percentage of merchandise imports. Because other categories of services and transfers (such as travel, transportation, and unrequited transfers) were virtually constant during 1981-82, we kept the same values for 1983-84.

Scheduled amortization, the remaining item needed for our 1983-84 financial gap analysis, consisted of principal payments on medium- and long-term external debt. We relied on IMF projections to forecast public and publicly guaranteed debt payments and used the value of 1982 private-sector payments as a proxy for amortization on private debt through 1984. The IMF amortization figures reflect IMF projections for debt relief on publicly guaranteed debt.

Table 6 summarizes the full range of our financial gap analyses covered under Case I in the main text. This projection series sets the financial conditions to which we then applied our security assumptions to consider possible changes in funding requirements.

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